DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

May 22, 2002

Number: **200235010**
Release Date: 8/30/2003
CC:INTL:BR02
PostF-104909-02
UILC: 955.02-01

INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

MEMORANDUM FOR AREA COUNSEL
CC:LM:CTM:SF

FROM: Phyllis E. Marcus
Branch Chief CC:INTL:BR02

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated February 22, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be used or cited as precedent.

LEGEND

Taxpayer =

Corp G =
Sub A =
Sub B =
Sub C =
Sub D =
Sub E =
Sub F =
Sub H =
Sub I =
Sub J =
Sub K =
Country A =
Country B =
Country C =
Industry A =

Product B =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Year 6 =
Date 7 =

ISSUE

Whether the Taxpayer's Year 2 election to have its shipping companies treated as a related group is effective in light of section 954(b)(2)'s repeal in 1986.

CONCLUSION

The election is ineffective.

FACTS

Taxpayer is involved in Industry A. A portion of its business includes shipping Product B and related products internationally. Taxpayer conducts its shipping business through several subsidiary shipping companies.

The tax years at issue are Years 3 through 5. In Year 5, Taxpayer reorganized its corporate structure to take advantage of the chain deficit rule of section 952(c)(1)(C).

A. Pre-Year 5 Organization

Prior to Taxpayer's reorganization in Year 5, Sub A, a domestic corporation, was a wholly owned subsidiary of Taxpayer. Sub H, a Country A corporation, was a wholly owned subsidiary of Sub A. Sub B, a Country C corporation, was also a wholly owned subsidiary of Sub A.

Sub B had two wholly owned subsidiaries, Sub F, a Country B corporation, and Sub C, a Country C corporation. Sub C had two wholly owned subsidiaries, Sub I and Sub J, both Country B corporations..

B. Year 5 and Post-Year 5 Organization

In Year 5, Taxpayer reorganized its various shipping companies. Sub F created a wholly owned subsidiary in Country B, Sub K. On Date 7, Sub C merged into Sub K. As a result of the merger, Sub J became a wholly owned subsidiary of

Sub K. Further in Year 5, Sub I sold its only ships to Sub C. Taxpayer states that Sub I will be merged into Sub K at some later date.

As a result of the reorganization in Year 5, all of Taxpayer's shipping companies, except Sub H, are in a vertical chain of companies owned by Sub B and incorporated in Country B.

C. Section 955 Related Group Elections

In Year 1, prior to 1987, Taxpayer filed a consolidated Federal income tax return with its various subsidiaries. Taxpayer attached a form to that return, electing to treat its various shipping companies as a related group. See Treas. Reg. §1.955A-3. Taxpayer's shipping companies included within the Year 1 election were Sub C, Sub D, and Sub E.

In Year 2, after 1986, Taxpayer filed a consolidated Federal income tax return with its various subsidiaries. Similar to its Year 1 return, Taxpayer attached a form electing to treat its various shipping companies as a related group. See Treas. Reg. §1.955A-3. Taxpayer's shipping companies included in the Year 2 election were Sub C, Sub F, Sub H, Sub I, and Sub J.

Sub C is the only subsidiary that appears on both elections. Sub D and Sub E no longer exist. Taxpayer had not made any other related group elections or modifications to the existing election between Year 1 and Year 2

Taxpayer utilized the related group election, specifically the related group excess deduction, for Years 3,4 and 5.

Taxpayer's position is that: (1) the group excess deduction is not inconsistent with the repeal of former section 954(b)(2), and (2) Congress validated the election when it amended section 955(a)(2)(A), but not section 955(b), under the Technical and Miscellaneous Revenue Act of 1988.

LAW AND ANALYSIS

1. Background.

The subpart F provisions enacted in 1962 severely limited the general rule of deferral until repatriation. Congress provided for immediate taxation of certain categories of income, but allowed continued deferral for other classes of income. Shipping income was partially favored under the subpart F regime, as Congress was encouraging investment in foreign shipping operations. Pursuant to section 954(b)(2), recognition of foreign base company shipping income was deferred to the extent such income was reinvested in foreign base company shipping

operations. This limited opportunity for deferral ended in 1987, when Congress repealed section 954(b)(2).

Section 954(b)(2), repealed by Public Law 99-514, section 1221(c)(1) (1986), provided that foreign base company income does not include foreign base company shipping income to the extent that the amount of such income does not exceed the increase for the taxable year in qualified investments in foreign base company shipping operations of the controlled foreign corporation. Under the statutory framework in place between 1962 and 1987, the exclusion for reinvested shipping income applied only to invested income that was "qualified."

Qualified investments in foreign base company shipping operations are defined in section 955(b)(1). Under the previously existing statutory framework, pursuant to Treas. Reg. §1.955A-3, a controlled foreign corporation could calculate its qualified investments on an individual basis or in conjunction with other controlled foreign corporations that qualified as "related persons." Any qualified investment would be treated separately unless the taxpayer elected the aggregate approach. The regulations provide this election through which a taxpayer can choose to consolidate its qualified investments with those of related persons. The regulations state:

> If a United States shareholder elects the benefits of section 955(b)(2) with respect to a related group ... of controlled foreign corporations, then an investment in foreign base company shipping operation made by one member of such group will be treated as having been made by another member to the extent provided in paragraph (c)(4) of this section, and each member will be subject to the other provisions of paragraph (c) of this section. An election once made shall apply for the taxable year for which it is made and for all subsequent years unless the election is revoked or a new election is made to add one or more controlled foreign corporations to election coverage.

Treas. Reg. §1.955A-3(a).

Thus, a U.S. shareholder was eligible to make the election only with respect to a related group of CFCs. One of the effects of the related group election was the ability to utilize the group excess deduction. See Treas. Reg. §1.955A-3(c)(2). Thus, an election as to qualified investments by related persons (related group election) was a prerequisite to the use of the group excess deduction. The related group election and the group excess deduction were inextricably linked.

The most direct and obvious consequence of the repeal of section 954(b)(2) was that taxpayers could no longer exclude foreign base shipping income by making qualified investments in foreign base shipping operations. The concept of

"qualified investments" became prospectively obsolete in that taxpayers could no longer except shipping income from subpart F, and the sum total of excluded income from qualified investments could no longer be increased. However, as a result of the repeal of section 954(b)(2), the previously excluded income was not subject to immediate recognition, and section 955 continues to recognize this income only when withdrawn from foreign base company shipping operations. Therefore, an accounting of a CFC's previously excluded income from qualified investments continues to be necessary, and the concept of "qualified investments" retains significance for this limited purpose.

2. Whether Taxpayer may in Year 2, after the repeal of section 954(b)(2), make an election to treat certain CFCs as part of a related group for purposes of utilizing the group excess deduction to reduce its overall taxable income.

Taxpayer cannot use the group excess deduction to reduce its overall taxable income by making a new related group election in Year 2, several years after section 954(b)(2)'s repeal.

Taxpayer originally made a related group election in Year 1 with respect to Sub C, Sub D, and Sub E. As the election was made prior to the repeal of section 954(b)(2), the election would be valid but for the fact that by Year 2, Sub D and Sub E were no longer in existence and the related group election made in Year 1 could not apply to a single corporation, Sub C.

In Year 2, Taxpayer sought to make a new related group election. Taxpayer intended the election to apply to Sub C, Sub F, Sub H, Sub I and Sub J and claimed the benefits from such election during Years 2, 3, 4, and 5.

A United States shareholder cannot make a new related group election after the repeal of section 954(b)(2). During the period when foreign base company shipping income used for "qualified investments" was excludable from subpart F income, the related group election enabled related taxpayers to work collectively to minimize that income. However, this exclusion for "qualified investments" in foreign base company shipping income was repealed as part of the Tax Reform Act of 1986.

Section 955(b)(2) arguably is authority for the related group election under Treas. Reg. §1.955A-3. Section 955(b), however, was not repealed along with section 954(b)(2). Section 955(b) does not have a purpose separate from section 954(b)(2). Section 955(b) is definitional and thus was needed and continues to be needed for purposes of implementing section 955(a), which deals with the withdrawal of previously excluded subpart F income from qualified investments.

The retention of section 955(b), however, does not authorize a U.S. shareholder to make a related group election that is first effective subsequent to the section 954(b)(2) repeal. As use of the group excess deduction is predicated upon a valid related group election, the group excess deduction is also unavailable under such circumstances. In addition, subpart F income generally is computed on an individual corporate basis. Neither section 954(f), nor Treas. Reg. §1.954-6, which provides rules for determining foreign base company shipping income, allows for computing that income on a group basis. Treas. Reg. §1.955A-3 is an exception to the general rule. In addition, in 1988, new chain deficit rules were enacted that allowed, in limited circumstances, deficits from shipping operations in one CFC to reduce foreign base shipping income in certain related CFCs. The related group election rules, including the group excess deduction, are more taxpayer favorable than the chain deficit rule. If, in fact, Congress believed that the related group election provisions under Treas. Reg. §1.955A-3 continued to exist, it would not have enacted a narrower chain deficit rule under section 952(c), to be applied to deficits from activities that would otherwise generate foreign base company shipping income.

Further, a reading of the provisions as a whole leads to the conclusion that Treas. Reg. §1.955A-3 cannot be used to compute foreign base company shipping income by a company making an initial election after the repeal of section 954(b)(2). The title of Treas. Reg. §1.955A-3: “election as to qualified investments by related persons,” clearly demonstrates that the election pertains to “qualified investments.” The concept of “qualified investments” became prospectively obsolete with the repeal of section 954(b)(2). To permit a first time election for Sub F, Sub H, Sub I and Sub J after the repeal of section 954(b)(2) would contravene the intent of the repeal.

The language found in Treas. Reg. §1.955A-1 also provides guidance for the analysis at hand. Treas. Reg. §1.955A-1(b)(2)(i)(C) explicitly states that a taxpayer’s share of the group excess deduction constitutes excluded subpart F income under section 954(b)(2). This language demonstrates that the group excess deduction is related to the section 954(b)(2) exclusions. As foreign base company shipping income is no longer excludable under section 954(b)(2), the group excess deduction is likewise unavailable to United States shareholders who first elect to use the deduction after repeal of section 954(b)(2).

The policy consideration implemented by repeal of section 954(b)(2), current recognition of shipping income earned through a foreign corporation, also suggests the curtailment of the group excess deduction.

Congress judged that shipping income is inherently manipulable, rarely subjected to foreign tax, and that it ought to be subject to subpart F when earned through a foreign corporation. The Congressional committee report states that as a

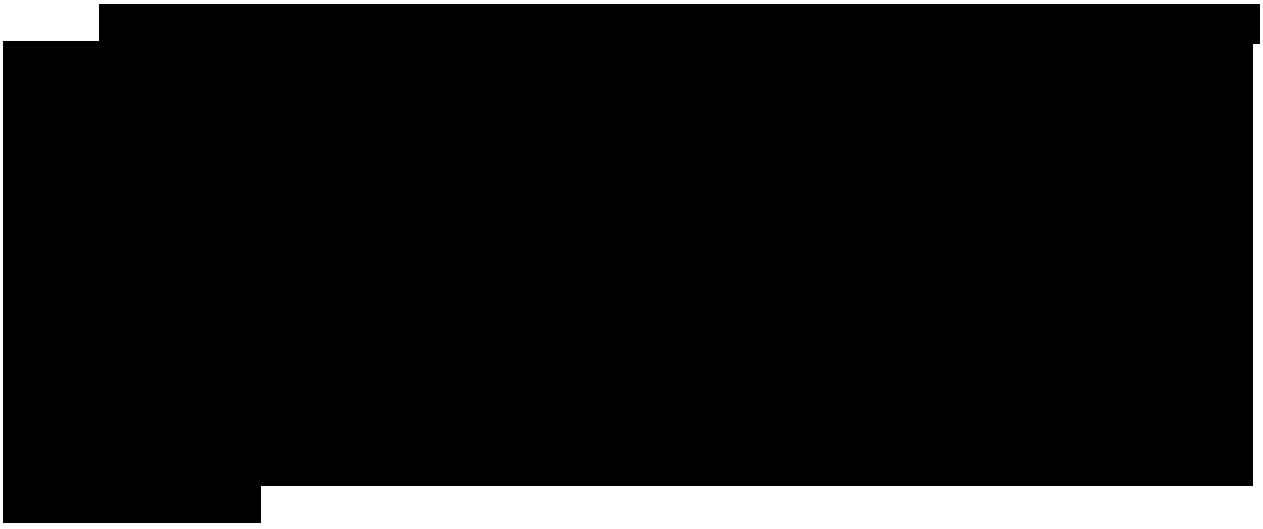
matter of tax policy that judgment should be given full effect. H.R. Rep. No. 99-426 at 391, 395 (1985).

The group excess deduction functions by enabling taxpayers to maneuver deductions in order to minimize current taxation. An initial attempt to use the group excess deduction after section 954(b)(2)'s repeal would frustrate Congress' intent to fully subject shipping income to current taxation and prevent manipulation of such income.

Lastly, the Taxpayer has raised a legislative reenactment issue. "Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law." Helvering v. Winmill, 305 U.S. 79, 82-83 (1938); U.S. v. Correll, 389 U.S. 299, 305-306 (1976) (quoting Helvering, 305 U.S. at 82-83); Cottage Savings Assoc. v. Commissioner, 499 U.S. 554, 561 (1991) (quoting Helvering, 305 U.S. at 82-83 and citing to Correll, 389 U.S. at 305-306). As stated previously, the Service does not contend that the regulations at issue are not valid, rather we contend that the regulations at issue have the same limited application as section 955(b) after the repeal of section 954(b)(2). As such, reliance on this line of cases is inappropriate to the facts at hand.

Based upon all of the above, Taxpayer cannot use the group excess deduction for the years in question.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call (202) 622-3840 if you have any further questions.

_____
PHYLLIS E. MARCUS
Branch Chief
CC:INTL:BR02